PART I

The Revocable Living Trust in Perspective

CHAPTER 1

Continuing Need for Estate Planning

TRANSFER TAX SYSTEM

For decades, estate planning has been significantly impacted by the federal transfer tax system; namely, estate tax, gift tax, and the generation-skipping transfer tax.

Federal Estate Tax

The U.S. government imposes an indirect progressive estate tax on the privilege of transferring property upon one's death.[1] The property to be valued for estate tax purposes is that which the decedent actually transfers at death, rather than the interest held by the decedent before death or that held by the legatee after death.[2] An estate tax credit (*applicable credit amount*) is allowed against the estate tax imposed by Internal Revenue Code (I.R.C.; Code) Section 2001 on the estate of every decedent who is a citizen or resident of the United States.[3] Because the estate tax is levied upon the "happening of an event" (death) and not on the "tangible fruits" of that event, it is an indirect excise tax. Furthermore, as an indirect tax, the U.S. Constitution does not prohibit Congress from imposing the estate tax. In fact, courts have upheld its constitutionality.[4] Furthermore, it has been held that the imposition of the estate tax is not a deprivation of equal protection under the law in violation of the U. S. Constitution.[5]

There exists a subtle dichotomy in the definition of the estate tax. On the one hand, the Treasury Regulations say that the estate tax is "neither a property tax nor an inheritance tax" but, rather, "is a tax imposed upon the transfer of the entire taxable estate and not upon any particular . . . distributive share." On the other hand, the Treasury Regulations say that the purpose of the federal estate tax is to tax the privilege of transferring the value of the estate owner's property at death.[6] In a way, this is all very interesting but quite academic. Not so academic, however, is the fact that, even though the estate tax is not levied

[1] *United States v. Manufacturers Natl. Bank of Detroit*, 363 U.S. 194, 198 (1960); *see* discussion in Chapter 8, sections on "Federal Estate Tax" and "Federal Estate Tax and Revocable Living Trust."

[2] *Propstra v. United States*, 680 F.2d 1248, 1250 (9th Cir. 1982); *see also Ahmanson Found. v. United States*, 674 F.2d 761, 769 (9th Cir. 1981); *Estate of Nowell v. Comm'r*, T.C. Memo 1999-15.

[3] I.R.C. § 2010(a). All section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

[4] Treas. Reg. § 20.0-2(a) and 20.0-2(b)(2); *N.Y. Trust Co. (Purdy Est.) v. Eisner*, 256 U.S. 345, 65 L.Ed. 963 (1921); *Heitsch v. Kavanagh*, 200 F.2d 178 (6th Cir. 1952).

[5] *Estate of Koester v. Comm'r*, T.C. Memo 2002-82.

[6] Treas. Reg. § 20.0-2(a) and 20.0-2(b)(2).

on a particular asset or a beneficiary's distributive share, it generally is payable before the asset is distributed to a beneficiary.

State law creates taxable legal interests and property rights in estates. The ultimate impact of the federal estate tax is controlled by state law. The federal estate tax is merely a tax imposed upon the *transfer of the value of property* at death; it does not control the method of distribution of that property to the decedent's beneficiary's or heirs.

Federal Gift Tax

Code Section 2501 imposes a progressive excise tax on the value of lifetime transfers of property by individual citizens or residents of the United States.[7] The first federal gift tax was imposed by the Revenue Act of 1924. Repealed by the Revenue Act of 1926, the gift tax was reinstituted by the Revenue Act of 1932. With modifications, it has remained part of the Code ever since.

The gift tax is not a property tax but, like the estate tax, is a progressive excise tax on the value of lifetime property transfers by individual citizens or residents of the United States.[8] The gift tax is an excise tax upon the donor's act of making the transfer and is measured by the value of the property passing from the donor to the donee. The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer.[9]

In the case of a gift by a nonresident alien, the gift tax applies only if the gift consisted of real property or tangible personal property situated within the United States at the time of the transfer.[10] As a general rule, except for shares of stock issued by a domestic corporation or debt obligations,[11] gifts of intangible personal property made by nonresident aliens on or after January 1, 1967, are not subject to the gift tax.[12] However, the gift tax does apply to the transfer of all property (whether real or personal, tangible, or intangible) situated in the United States at the time of the transfer, if either (1) the gift was made on or after January 1, 1967, by a nonresident alien who was an expatriate to whom I.R.C. Section 2501(a)(2) was inapplicable on the date of the gift by reason of I.R.C. Section 2501(a)(3) and Treasury Regulation Section 25.2501-1(a)(3) or (2) the gift was made before January 1, 1967, by a nonresident alien who was engaged in business in the United States during the calendar year in which the gift was made.[13]

Observation

A donor's parents were born in Puerto Rico in 1895 and 1896, respectively, and never filed a declaration of allegiance to Spain. The donor's parents were domiciled in Puerto Rico their entire lives, except for one period from 1924 through 1935. From 1924 through 1926, they resided in another country, where, in 1926, the donor was born. From 1927 to 1935, the donor and the donor's parents resided in yet another country. The donor has resided in Puerto Rico at all times since 1935.

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[7] Treas. Reg. § 25.2511-2(a); *see* discussion in the "Federal Gift Tax" and "State Gift Tax" sections in Chapter 8.

[8] Treas. Reg. § 25.2511-2(a).

[9] Rev. Rul. 77-378, 1977-2 C.B. 348. *See* Treas. Reg. § 25.2511-2(a).

[10] Treas. Reg. § 25.2511-1(b).

[11] I.R.C. § 2511(b).

[12] I.R.C. § 2501(a)(2); Treas. Reg. §§ 25.2501-1(a)(3)(i), 25.2511-1(b), 25.2511-3(a)(i).

[13] Treas. Reg. § 25.2511-3(a)(2).

The donor's citizenship was derived from Puerto Rican citizenship by operation of the Foraker Act and the donor's U.S. citizenship under the Jones Act by virtue of Puerto Rican citizenship or under 8 U.S.C. 1401(c) and its predecessor statutes. Under these circumstances, the donor's citizenship is derived solely from the donor's citizenship with respect to a United States possession for purposes of applying I.R.C. Sections 2209 and 2501(c). Thus, for purposes of the U.S. gift tax, the donor is considered a *nonresident—not a citizen of the United States*.[14] Such a donor will continue to be considered a nonresident—not a citizen of the United States—for such time as the donor remains a resident of Puerto Rico or another outlying United States possession.[15]

The gift tax is based upon the amount of the gift; and, if the gift is made in property, its *value* on the date of the gift is considered the amount of the gift.[16] An alternate valuation date is not available with respect to determining the amount of gift tax, as is the case with I.R.C. Section 2032 for estate tax valuation. The value of the property gifted is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[17]

Five types of transfers are not subject to the gift tax: (1) transfers to political organizations;[18] (2) transfers to charitable organizations;[19] (3) gifts that qualify for the unlimited gift tax marital deduction;[20] (4) gifts that qualify for the gift tax annual exclusion;[21] and (5) gifts that qualify for the educational and medical expenses exclusion.[22] Gifts that qualify for the gift tax annual exclusion are indexed for inflation.[23] Finally, the gift tax is not imposed upon the receipt of property by the donee; nor is it necessarily determined by the donee's enrichment or benefit from the gift.[24]

Generation-Skipping Transfer Tax

Before the Tax Reform Act of 1976 (TRA '76), successive estate tax could be avoided from one generation to another by placing property in trust for beneficiaries of two or more generations younger than the grantor (transferor). For example, a grandparent could establish a trust for the benefit of his or her children and grandchildren and avoid estate tax at the children's generation. In other words, for gift and estate tax purposes, the trust property skipped one generation (children of the grantor) on its way from the grandparent to the child and then to the grandchild.

In an effort to reduce lost revenue from this planning technique, Congress enacted, as part of TRA '76, the generation-skipping transfer tax (GSTT) into the Code as Chapter 13. The GSTT was designed to be substantially equivalent to the tax that would have been imposed if the property had actually been transferred outright to each successive

[14] *See* Treas. Reg. § 25.2501-1(d), examples 2 and 5, and Treas. Reg. § 20.2209-1, examples 2 and 5.

[15] *See* Rev. Rul. 74-25, 1974-1 C.B. 284; Priv. Ltr. Rul. 9720029 (February 13, 1997).

[16] Treas. Reg. § 25.2512(a).

[17] Treas. Reg. § 25.2512-1.

[18] I.R.C. § 2522(a)(1).

[19] I.R.C. § 2522(a)(2).

[20] I.R.C. § 2523(a).

[21] I.R.C. § 2503(b).

[22] I.R.C. § 2503(e).

[23] I.R.C. § 2503(b)(2).

[24] Treas. Reg. § 25.2511-2(a), (b).

generation.[25] The GSTT is imposed in addition to any federal gift tax on lifetime transfers or estate tax imposed at death.

Observation

Certain interests are disregarded if the primary purpose of the interest is to avoid any GSTT. For example, if a transferor placed property in a trust that is to pay income to a great-grandchild for a relatively short period then income to a grandchild for life, with the remainder going back to a great-grandchild, in order to avoid a second imposition of the GSTT, the income interest of the great-grandchild would be disregarded so that GSTT would be imposed upon the death of the grandchild. Such an interest would be disregarded, even though distributions to the great-grandchild are taxable distributions.[26]

Furthermore, parental support obligations may be disregarded in determining a parent's interest in a generation-skipping transfer (GST) trust. Provided the parent's use of trust principal or income to satisfy support obligations is discretionary or pursuant to any state law substantially equivalent to the Uniform Gifts to Minors Act, the parent will not be considered to have an *interest* in the trust for GST purposes. Thus, a parent is not treated as having an interest in a trust by reason of powers the parent may have as guardian for the child. On the other hand, a parent will be treated as having an interest in a trust if the trust instrument requires that trust assets be used to discharge the parent's support obligation.[27]

Example

Grandparent establishes an irrevocable trust for the benefit of grandparent's grandchild. The trustee has discretion to distribute property for the grandchild's support without regard to the duty or ability of the grandchild's parent to support the grandchild. Because the grandchild is a permissible current recipient of trust property, the grandchild has an interest in the trust. The grandchild's parent does not have an interest in the trust because the potential use of the trust property to satisfy the parent's support obligation is within the discretion of a fiduciary. The grandchild's parent would be treated as having an interest in the trust if the trustee was required to distribute trust property for the grandchild's support.[28]

Under the Tax Reform Act of 1986 (TRA '86),[29] a GST means a *taxable distribution*, a *taxable termination* and a *direct skip*.[30] In each case, a GST of *income* or *principal* to a beneficiary who is at least two generations younger than the transferor (grantor) is subject to the GSTT. The term *generation-skipping transfer* does not include:

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[25] Lloyd Leva Plaine, "The Proposed Generation-Skipping Transfer Tax in the House-Passed Tax Reform Bill," *Tax Management Estates, Gifts and Trusts Journal* 63-64 (May-June 1986) (hereafter, Plaine, *The Proposed Generation-Skipping Transfer Tax*).

[26] *Technical and Miscellaneous Revenue Act of 1988*, Pub. L. No. 100-647, 100th Cong., 2d Sess. (10 November 1988), 1988-3 C.B. 1, S. Rep. at 1173 (hereafter TAMRA '88).

[27] I.R.C. §§ 2652(c)(3) and 2642(c)(2).

[28] Treas. Reg. § 26.2612-1(f), example (15).

[29] *Tax Reform Act of 1986*, Pub. L. No. 99-514, 99th Cong., 2d Sess. (22 October 1986), 1986-3 C.B. 1 (hereafter TRA '86).

[30] I.R.C. §§ 2601 and 2611(a).

- A property transfer, subject to estate or gift tax, to a person in the first generation below the grantor's (transferor's) generation.[31] For example, grandparent transfers property valued at $50,000 outright to grandparent's child; this is not a GST. Or an aunt or an uncle transfers property valued at $100,000 to a nephew or a niece; this is not a GST.
- Any lifetime gift that qualifies for the gift tax annual exclusion under I.R.C. Section 2503(b) or qualified transfers under I.R.C. Section 2503(e) for educational or medical expenses.[32] Similarly, a GST does not include such gifts made in trust after March 31, 1988, provided: (a) during the life of the beneficiary, no portion of the principal or income of the trust may be distributed to or for the benefit of anyone other than such beneficiary; and (b) if the beneficiary dies before the trust is terminated, the assets of the trust will be includable in the gross estate of the beneficiary.[33]
- Any property transfer to the extent the property transferred was subject to a prior GSTT.[34]
- Any GST under a trust [as defined in I.R.C. Section 2652(b)] that was irrevocable on September 25, 1985. This rule does not apply to a pro rata portion of any GST under an irrevocable trust if additions are made to the trust after September 25, 1985.[35]
- Any GST under a trust that is a direct skip, occurring by reason of a decedent's death, is not subject to the GSTT if the decedent was legally incompetent on October 22, 1986, and at all times thereafter until death.[36] However, the incompetency exemption does not apply to property received by the transferor from another person by lifetime gift or testamentary transfer after August 3, 1990.[37]

Proceeds from the settlement of a wrongful death lawsuit (other than the amounts attributable to pain and suffering and reimbursements for medical expenses) not included in decedent's gross estate are not subject to the GSTT.[38]

Examples

1. Grandparent transfers property valued at $50,000 outright to a grandchild. If the grandchild's parent is alive at the time of the transfer, the transfer of the property to the grandchild is a GST. The taxable amount of the gift for purposes of the GST tax is $39,000 [$50,000 – $11,000 gift tax annual exclusion for a gift of a present interest (2002) = $39,000]. Whether grandparent pays any GST tax depends on the extent of the grandparent's unused GST tax exemption.

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[31] I.R.C. § 2611(b)(2)(B).

[32] I.R.C. §§ 2611(b)(1), 2642(c)(3). *See also* Priv. Ltr. Rul. 9124018 (March 14, 1991) (the merger of two trusts will not result in an addition to corpus for GST purposes and will not result in a taxable gift within the meaning of I.R.C. § 2501).

[33] I.R.C. § 2642(c); Treas. Reg. § 26.2642-1(c)(3). *See also* Priv. Ltr. Rul. 9124018 (March 14, 1991) (the merger of two trusts will not result in an addition to corpus for GST purposes and will not result in a taxable gift within the meaning of I.R.C. § 2501).

[34] I.R.C. § 2611(b)(2)(A).

[35] Treas. Reg. § 26.2601-1(b)(1)(i).

[36] TRA '86 § 1433(b)(2)(C).

[37] *Revenue Reconciliation Act of 1990 (H.R. 5835) Law and Explanation* [Extra Edition No. 48], Stand. Fed. Tax Rep. (CCH) § 11703(c)(3) amending § 1433(b)(2)(C) of the Tax Reform Act of 1986 and § 11703(c)(4) (hereafter RRA '90 Law and Explanation).

[38] Priv. Ltr. Rul. 9622035 (March 4, 1996).

2. Grandparent creates a trust for grandparent's child and grandchild. If the trustee distributes income or principal to the grandchild during the life of the child, that distribution is a GST.
3. Grandparent creates a testamentary trust and provides a life estate for grandparent's child with remainder to grandchild. Child receives income only from the life estate and has no power over the beneficial enjoyment of the life estate trust assets. In the event of the child's death, because the value of the assets composing the life estate trust is not includable in the child's gross estate, it is not subject to estate tax. In effect, for estate tax purposes, the assets of the life estate trust have skipped the child's generation on their way to the grandchild. Such an arrangement constitutes a GST.

With respect to the exemption from GSTT for a decedent who was mentally incompetent on October 22, 1986, and at all times thereafter until death, if a court has not adjudicated the decedent mentally incompetent on or before October 22, 1986, the executor must file, with Form 706, either: A certification from a qualified physician stating that the decedent was mentally incompetent at all times on and after October 22, 1986, and did not regain competence to modify or revoke the terms of the trust or will prior to his or her death; or sufficient other evidence demonstrating that the decedent was mentally incompetent at all times on and after October 22, 1986, as well as a statement explaining why no certification is available from a physician; and any judgment or decree relating to the decedent's incompetency which was made after October 22, 1986. Such items will be considered relevant but not determinative in establishing the decedent's state of competency. If the decedent has been adjudged mentally incompetent on or before October 22, 1986, a copy of the judgment or decree, and any modification thereof, must be filed with the Form 706.[39] The term *mental disability* means mental incompetence to execute an instrument governing the disposition of the individual's property, whether or not there was an adjudication of incompetence and regardless of whether there has been an appointment of a guardian, fiduciary, or other person charged with either the care of the individual or the care of the individual's property.[40] However, where the decedent's executor did not file the required certification with the Form 706 and the decedent's physician and records were currently available, the Internal Revenue Service (IRS or the Service) ruled that the government's interest was not jeopardized by the delay in filing the required information on the decedent's mental condition. Accordingly, a GST trust was not disqualified from eligibility for the mental incompetency exemption contained in the transitional rule solely as a result of the late filing of the necessary documents relating to the decedent's mental condition.[41]

Since a decedent was mentally incompetent on October 22, 1986, until the time of his death, the IRS ruled that the reverse qualified terminable interest property (QTIP) election had been made by the decedent and that the inclusion of the value of QTIP marital trust in the surviving spouse's gross estate pursuant to I.R.C. Section 2044 would not affect the exempt status of the trust for GSTT purposes. The decedent executed his will in 1982 and died in 1992. The decedent's Form 706 contained the statement and the physician's certification regarding the decedent's mental incompetency as required by Treasury Regulations Section 26.2601-1(b)(3)(iii). The Service accepted the return as filed, and the federal estate tax closing letter was issued by the Service on April 29, 1994. Therefore, because the Service agreed that the decedent was under a mental disability to change the disposition of his property continuously from October 22, 1986, until the date of his death, the GSTT did not

[39] Treas. Reg. § 26.2601-1(b)(3)(iii), (iv).

[40] Treas. Reg. § 26.2601-1(b)(3)(ii).

[41] Priv. Ltr. Rul. 9535039 (June 2, 1995).

apply to any GST under a QTIP marital trust established under the decedent's will. In addition, because the decedent could not, by reason of incompetency, change his will as of October 22, 1986, the provisions of the will would have been on that date, and dating back to September 25, 1985, as a practical matter, irrevocable. Consequently, the Service concluded that the provisions applicable to the grandfathering of irrevocable trusts[42] were applicable to the QTIP marital trust and that the decedent's estate would be deemed to have made a reverse QTIP election[43] with respect to the marital trust.[44]

IMPACT OF TAX LEGISLATION

Tax Reform Act of 1976

The Tax Reform Act of 1976 (TRA '76)[45] changed significantly the strategies and planning techniques used by estate owners to plan their estates. Before 1977, two separate tax rate schedules applied to lifetime gifts and transfers of property at death. Congress viewed the two-tax-rate system as a way for people to avoid paying the higher tax on the real value of property at death. Furthermore, Congress viewed lifetime transfers as a tax-reducing vehicle afforded to only the wealthy and generally unavailable for those of small and moderate wealth. These estate owners generally want to retain their property until death to assure financial security during lifetime. TRA '76 consolidated the gift and estate tax rates to create a single unified transfer tax and credit system. This unified rate schedule provides progressive rates and applies to decedents dying after December 31, 1976, and to cumulative lifetime gifts made after that date.

For federal estate tax purposes, TRA '76 introduced special use valuation as a new method for the valuation of real property used as a farm for farming purposes or in a trade or business other than the trade or business of farming.[46] Additionally, with the introduction of the generation-skipping transfer tax, estate planning can no longer be undertaken just once every other generation. No longer can the attorney simply design a trust with the income to the estate owner's children for life and the principal to his or her grandchildren without taking into account the impact of the generation-skipping transfer tax. Changes in the federal estate tax marital deduction further complicated the use of formulas in order to ensure effective use of the marital deduction for property passing under the decedent's will and for property passing outside the will to the decedent's surviving spouse.

Economic Recovery Tax Act of 1981

The new planning strategies and techniques brought about by TRA '76 were followed and further influenced by the complex rules found in the Economic Recovery Tax Act of 1981 (ERTA '81).[47] Perhaps the most profound and significant change introduced by ERTA '81

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[42] TRA '86 § 1433(b)(2)(A) and Treas. Reg. § 26.2601-1(b)(1)(i).

[43] I.R.C. § 2652(a)(3).

[44] Priv. Ltr. Rul. 9639015 (June 14, 1996). *See also* Priv. Ltr. Rul. 9741025 (July 11, 1997) (because decedent could not by reason of incompetency change her will as of October 22, 1986, the provisions of the will would have been, on that date, and dating back to September 25, 1985, as a practical matter, irrevocable).

[45] *Tax Reform Act of 1976*, Pub. L. No. 94-455, 94th Cong., 2d Sess. (24 October 1976), 1976-3 (Vol. 1) C.B. 1 (hereafter TRA '76).

[46] I.R.C. § 2032A(a)(1) and (b)(2).

[47] *Economic Recovery Tax Act of 1981*, Pub. L. No. 97-34, 97th Cong., 1st Sess. (13 August 1981), 1981-2 C.B. 256 (hereafter ERTA '81).

was the unlimited federal estate tax marital deduction. No single estate and gift tax planning benefit has been more misunderstood and misused by married persons than the unlimited estate tax marital deduction. Its misuse, in conjunction with the federal estate tax exemption amount, has done more than any other single factor to cause the payment of additional and unnecessary federal estate tax upon the subsequent death of the surviving spouse.

Even before ERTA '81 became law, someone created the absurd notion that it would eventually eliminate approximately "99.6 percent of all estates from estate and gift taxes!" Unfortunately, many people believed this—probably because it was what they wanted to hear. Apparently, though, because of the increased amounts exempt from estate and gift tax, the new unlimited estate and gift tax marital deduction, and the reduction in estate and gift tax rates, many people erroneously dismissed the importance of estate planning. Similar inertia to engage in estate planning is affecting many people in view of The Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Act).[48] Indeed, it is absurd to think that estate planning is no longer necessary just because the 2001 Act has increased the amount exempt[49] from federal estate tax.

Tax Reform Act of 1986

The Tax Reform Act of 1986 (TRA' 86)[50] substituted the Code of 1986 for the Code of 1954. TRA '86 replaced the generation-skipping transfer tax rules established under TRA '76 by imposing a completely new set of rules. Gone also were many of the loopholes upon which generations of practitioners and estate owners had come to rely for the avoidance of transfer tax on their wealth. President Ronald Reagan hailed TRA '86 as the "most sweeping overhaul of our tax code in our nation's history."

Revenue Reconciliation Act of 1990

In yet another attempt to feed its insatiable spending appetite and wring more revenue out of the already overburdened American taxpayer, Congress passed the Revenue Reconciliation Act of 1990 (RRA '90).[51] The provisions of RRA '90 significantly impacted the use of retained life estates as a technique for reducing the value of the gross estate subject to federal estate tax. In addition, the special valuation rules of I.R.C. Sections 2701-2704 were added to the Code, which severely curtailed the so-called *estate-freezing* technique previously used by many closely-held business owners. This technique was used as a means of shifting to their children the appreciation in value on closely-held stock owned by parents, thereby reducing the value of the stock included in the parents' gross estate for federal estate tax purposes. Moreover, I.R.C. Sections 2701-2702 and 2704 have rendered it more difficult for older family members to transfer interests in closely-held businesses to younger family members without incurring gift tax.

The decade of the eighties may very well be remembered as producing more tax legislation than any other in twentieth-century American history. Practitioners and estate owners

[48] *The Economic Growth and Tax Relief Reconciliation Act of 2001*, Pub. L. No. 107-16, 107th Cong., 1st Sess. (7 June 2001) (hereafter the 2001 Act).

[49] The amount exempt from federal estate tax is the *applicable exclusion amount*, which is commonly referred to as the *exemption amount*.

[50] *Tax Reform Act of 1986*, Pub. L. No. 99-514, 99th Cong., 2d Sess. (22 October 1986), 1986-3 C.B. 1 (hereafter TRA '86).

[51] *Revenue Reconciliation Act of 1990* in *Omnibus Budget Reconciliation Act of 1990*, Pub. L. No. 101-508, 101st Cong., 2d Sess. (1990), 1991-2 C.B. 481 (hereafter RRA '90).

must continue to deal with complexities in the myriad tax laws enacted since TRA '76. In its continuing effort to "simplify" the tax laws, Congress continues to rely on its members and their aides whose theoretical abilities overshadow their practical and real-life experiences in designing comprehensive and simplified tax laws. At the other extreme, the irony of politicians, lawyers, and accountants discussing ways to reduce the complexity of the tax laws is, in the words of former Joint Committee on Taxation Chief of Staff David H. Brockway, "like going to a Hell's Angels Conference on the decline of social graces in America. . . . We *are* the problem." It seems that one tax act is only replaced by new legislation as esoteric and confusing to estate owners as the already unmanageable law it modified or replaced. Additional complexity and confusion have been created because some of the tax acts themselves have amended previous tax acts, the provisions of which have not become part of the Code. Overall, much of the legislation resulting in the myriad tax acts was poorly conceived, poorly drafted, and leaned more heavily for implementation on regulations,[52] many of which have not yet been drafted.

Taxpayer Relief Act of 1997

The Taxpayer Relief Act of 1997 ("the 1997 Act")[53] enacted several changes that move trusts and estates toward closer tax parity and effected myriad other technical changes to the Code with respect to estate, gift, and generation-skipping transfer taxes. All of these changes add further complexity to the estate-planning process. The federal estate tax exemption amount was to have increased from $600,000 in 1997 to $1 million in 2006 and thereafter.[54] After 1998, the $10,000 gift tax annual exclusion, the $750,000 ceiling on special use valuation, the $1 million generation-skipping transfer tax exemption, and the $1 million ceiling on the value of closely-held business interests eligible for the special low interest rate for deferred payment of federal estate tax are all indexed annually for inflation.[55] In addition, under the 1997 Act, the executor of a decedent's estate may elect special estate tax treatment for qualified family-owned business interests, if such interests comprise more than 50 percent of a decedent's estate and certain other requirements are met. In general, the provision excludes the first $1 million of value in qualified family-owned business interests from a decedent's taxable estate.[56] With respect to the deferred payment of federal estate tax attributable to the value of closely-held business interests included in the decedent's estate, the 1997 Act reduces the 4 percent interest rate to 2 percent and makes the interest paid on estate tax deferred under I.R.C. Section 6166 nondeductible for estate and income tax purposes. Finally, as a general rule, the Service cannot revalue a gift for estate tax purposes after expiration of the statute of limitations, provided the gift is adequately disclosed on a gift tax return.

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[52] Commerce Clearing House Tax Advisory Board, "The Changing Practice of Tax Law for Lawyers and Accountants," 72 *Taxes* 190, 207 (April 1994) (hereafter, CCH Tax Advisory Board, "Practice of Tax Law for Lawyers and Accountants").

[53] *Taxpayer Relief Act of 1997*, Pub. L. No. 105-34, 105th Cong., 1st Sess. (1997), 111 Stat. 788 (hereafter "the 1997 Act").

[54] *But see* discussion under "Federal Estate Tax Exempt Amount Increased" section, *infra* for changes made to the exemption amount by *The Economic Growth and Tax Relief Reconciliation Act of 2001*, Pub. L. No. 107-16, 107th Cong., 1st Sess. (7 June 2001) (hereafter "the 2001 Act").

[55] *But see* discussion under "Federal Estate Tax Exempt Amount Increased" section, *infra* for changes made to generation-skipping transfer exemption amount beginning in 2002 under the 2001 Act.

[56] *But see* discussion under "Family-Owned Business Interest Deduction" section, *infra* regarding repeal of the qualified family-owned business interest deduction after December 31, 2003, I.R.C. § 2057(j).

THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

Overview

Congress added more unnecessary complexity to the Code by enacting the 2001 Act. Congress added new rules that will significantly impact estate planning for the next several years. The 2001 Act is truly unique in that never before has Congress enacted a tax act based on ten-year revenue projections. Estate planners must now address clients' estate planning needs and objectives by employing the rules promulgated under TRA '76, ERTA '81, TRA '86, the 1997 Act, and what may well prove to be nonpermanent rules under the 2001 Act.

Repeal of the Federal Estate and Generation-Skipping Transfer Tax

Perhaps the most significant impact of the 2001 Act is the scheduled repeal of the federal estate and generation-skipping transfer tax after December 31, 2009.[57] However, the federal gift tax is not repealed; and the maximum federal gift tax exemption amount is $1 million in 2002 and thereafter.[58]

Federal Estate Tax Exemption Amount Increased

The 2001 Act phases in a new applicable exclusion amount (exemption amount) and applicable credit amount,[59] which is gradually increased to shelter from federal estate tax $3.5 million of the value of property transferred at death. The exemption, referred to as the *applicable exclusion amount*[60] (exemption amount), and the unified credit, referred to as the *applicable credit amount*[61] (unified credit), is $1,000,000 and $345,800, respectively, in 2003.[62] In the case of estates of decedents dying in calendar years after 2002 and before 2010, the tentative federal estate tax will be determined by using a table prescribed by the IRS [in lieu of using the table contained in I.R.C. Section 2001(c)(1) which will be the same table, except that the maximum rate of tax for any calendar year will be the rate discussed below; and the marginal federal estate tax brackets and the amounts setting forth the tax will be adjusted to the extent necessary to reflect the adjustments made by the reduction in the maximum federal estate tax rate].[63] From 2002 through 2009, the maximum federal estate tax rates and the exemption amount are shown in Exhibit 1.1 :[64]

The exemption amount is reduced (but not below zero) by the sum of (1) the amount of decedent's taxable gifts (adjusted taxable gifts) made after December 31, 1976, which are not includable in the decedent's gross estate and (2) the aggregate amount of the pre-TRA '76 $30,000 specific gift tax exemption allowed for gifts made by the decedent after September 8, 1976. In effect, the *exemption amount* is the reciprocal of the unified credit. The *exemption* is the amount of the gross estate exempt from (not subject to) federal estate tax or

[57] I.R.C. §§ 2210(a); 2664 flush language and (d).
[58] I.R.C. § 2505(a)(1); the 2001 Act, § 521(b), (e)(2).
[59] In effect, the unified credit is the tax credit equivalent of the exemption amount.
[60] I.R.C. § 2010(c).
[61] I.R.C. § 2010(a).
[62] I.R.C. §§ 2001(c)(1), 2010(c).
[63] I.R.C. § 2001(c)(2)(A).
[64] I.R.C. §§ 2001(c)(2) and 2010(c).

Exhibit 1.1 Maximum Federal Estate Tax Rates And The Exemption Amount

Calendar Year	Estate and GST Tax Deathtime Transfer Exemption Amount	Highest Estate and Gift Tax Rates
2002	$1 million	50 percent
2003	$1 million	49 percent
2004	$1.5 million	48 percent
2005	$1.5 million	47 percent
2006	$2 million	46 percent
2007	$2 million	45 percent
2008	$2 million	45 percent
2009	$3.5 million	45 percent
2010	N/A (taxes repealed)	Top individual income tax rate

gift tax on lifetime gifts in excess of the gift tax annual exclusion amount or gift tax marital deduction. Conversely, the *unified credit* is a tax credit equivalent to the amount that is exempt from federal estate (or gift) tax and is subtracted from the tentative tax due (estate or gift tax). The applicable exclusion amount of the unified credit is not indexed for inflation.

With respect to the generation-skipping transfer tax, for estates of decedents dying, and generation-skipping transfers, *before* January 1, 2004, the GST exemption amount is $1 million subject to an inflation adjustment.[65] This adjustment is obtained by multiplying $1 million by the cost-of-living adjustment determined under I.R.C. Section 1(f)(3) for such calendar year by substituting "calendar year 1997" for "calendar year 1992" in subparagraph (B) thereof.[66] The generation-skipping transfer tax exemption amount for the year 2003 is $1,120,000.[67] For decedents dying, and generation-skipping transfers, *after* December 31, 2003, the GSTT exemption amount for any calendar year will not be indexed for inflation but will be equal to the applicable exclusion amount under I.R.C. Section 2010(c) for such calendar year.[68] Thus, in 2004 and 2005, the GSTT exemption amount is $1.5 million; in 2006, 2007, and 2008, the GSTT exemption amount is $2 million; and, in 2009, the GSTT exemption amount is $3.5 million.[69]

Payment of Federal Gift Tax on Transfer of Property to Trust

After December 31, 2009, the top federal gift tax rate will be the top individual income tax rate (35 percent);[70] and, except as provided in regulations, the transfer to a trust will be treated as a taxable gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provision of I.R.C. Sections 671-678.[71] Since the revocable living trust (RLT) is governed for tax purposes by I.R.C. Sections 671-678, the conveyance of title to assets to a revocable living trust is not a gift taxable event. Thus, as a general rule, none of the trustor's exemption amount is used up in effecting such conveyances.

[65] I.R.C. § 2631(a) and (c).

[66] I.R.C. § 2631(c)(1).

[67] Rev. Proc. 2002-70, 2002-46, I.R.B. 1 at .25.

[68] I.R.C. § 2631(c) applicable to estates of decedents dying, and generation-skipping transfers after December 31, 2003.

[69] I.R.C. §§ 2010(c); 2631(a) and (c).

[70] I.R.C. § 2502(a)(2).

[71] I.R.C. § 2511(c).

Federal Estate and Gift Tax Rates Reduced

The 2001 Act reduces the federal estate and gift tax rates. The maximum federal estate and gift tax rate for taxable estates and gifts in excess of $2.5 million in 2003 is 49 percent; 2004, 48 percent; 2005, 47 percent; 2006, 46 percent; and, in 2007, 2008, and 2009, 45 percent.[72] In 2002, the 5 percent surtax (which phased out the benefit of the graduated rates) was repealed.[73] As previously mentioned, the maximum federal gift tax rate after 2009 is scheduled to be 35 percent.[74]

Family-Owned Business Interest Deduction

In 2004, the qualified family-owned business interest deduction is repealed.[75]

State Death Tax Credit

Under the 2001 Act, from 2002 through 2004, the state death tax credit rate is, in effect, decreased from a maximum of 16 percent as follows: to 12 percent in 2002, to 8 percent in 2003, and to 4 percent in 2004. The amount of state death tax credit shown in the table in I.R.C. Section 2011(b) is reduced by 25 percent in 2002, 50 percent for the estates of decedents dying in 2003, and 75 percent for the estates of decedents dying in 2004.[76] The state death tax credit is repealed for estates of decedents dying after December 31, 2004.[77] In 2005, after the state death tax credit is repealed, there will be a deduction for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any state or the District of Columbia in respect of property included in the decedent's gross estate.[78]

REPEAL OF STEPPED-UP BASIS

Another significant change under the 2001 Act affecting estate plans now and after 2009 is the repeal of stepped-up basis for property in the hands of a beneficiary received from a decedent's estate after December 31, 2009.[79]

Modified Carryover Basis

After repeal of the federal estate and generation-skipping transfer tax,[80] the basis of assets acquired from a decedent for income tax reporting purposes, generally, will equal *the lesser of* the basis of the decedent (i.e., carryover basis) at death or the fair market value of the property at the date of the decedent's death.[81] However, a decedent's estate is permitted to increase the basis of appreciated assets transferred to any beneficiary by up to a total of $1.3 million (i.e., the basis of the asset(s) may be *modified*).[82] The basis of appreciated property

[72] I.R.C. § 2001(c)(2)(B).

[73] The 2001 Act, § 511(b) and (f)(1).

[74] I.R.C. § 2502(a)(2).

[75] I.R.C. § 2057(j).

[76] I.R.C. § 2011(b)(2); the 2001 Act, § 531(b).

[77] I.R.C. § 2011(g).

[78] I.R.C. § 2058(a).

[79] I.R.C. § 1014(f).

[80] I.R.C. § 1022(a)(1).

[81] I.R.C. § 1022(a)(2).

[82] I.R.C. § 1022(b)(2)(B).

transferred to a surviving spouse can be increased (i.e., stepped-up) by an additional $3 million.[83] Thus, the basis of property transferred to a surviving spouse can be increased (i.e., stepped-up) by a total of $4.3 million.[84] With respect to the $1.3 million and $3 million amounts, the decedent (e.g., the trustor) will be treated as owning property transferred by the decedent during his or her lifetime to a qualified revocable trust, as defined in I.R.C. Section 645(b)(1).[85] In no case can the basis of an asset be adjusted above its fair market value.[86] For these purposes, the decedent's personal representative will determine which assets and to what extent each asset receives a basis increase.[87] The $1.3 million and $3 million amounts are adjusted annually for inflation occurring after 2010.[88]

New Reporting Requirements for Large Transfers

Under the 2001 Act, new reporting requirements are imposed with respect to carryover basis. For transfers at death *after* December 31, 2009, of *noncash* assets in excess of $1.3 million[89] (so-called *large transfers*), and for appreciated property, the value of which exceeds $25,000 (except for gifts to charitable organizations)[90] received by a decedent within three years of death,[91] the decedent's personal representative (or the trustee of a revocable trust) would report[92] to the IRS:[93]

- The name and taxpayer identification number of the recipient of the property;
- An accurate description of the property;
- The adjusted basis of the property in the hands of the decedent and its fair market value at the time of death;
- The decedent's holding period for the property;
- Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income;
- The amount of basis increase allocated to the property; and
- Any other information as the Treasury Secretary may prescribe by regulation.

Information Furnished to Recipient of Property

In addition, every person required to report *large transfers* to the IRS is required to furnish not later than 30 days after the date the return is filed[94] to each person (i.e., beneficiary, heir, or property recipient) whose name is required to be listed in such return (other than the

[83] I.R.C. § 1022(c)(2)(B).

[84] I.R.C. § 1022(c)(1).

[85] I.R.C. § 1022(d)(1)(B)(ii).

[86] I.R.C. § 1022(d)(2).

[87] I.R.C. § 1022(d)(3)(A).

[88] I.R.C. § 1022(d)(4)(A).

[89] I.R.C. § 6018(b)(1).

[90] *Economic Growth and Tax Relief Reconciliation Bill 2001 (H.R.. 1836), Descriptions Contained in the Conference Committee Report on H.R. 1836, the Economic Growth and Tax Relief Reconciliation Bill of 2001*, as released on May 30, 2001, Fed. Est & Gift Tax Rep. (CCH), ¶ 29,056, 44,145, 44,151 (hereafter *Conference Committee Report on H.R. 1836*).

[91] I.R.C. § 6018(b)(2).

[92] I.R.C. § 6018(b)(4).

[93] I.R.C. § 6018(c).

[94] I.R.C. § 6018(e) flush language.

person required to make such return) a written statement showing: the name, address, and phone number of the person required to make such return and the information described above which is reportable to the IRS on the return.[95]

Penalties

The required return is to be filed with the decedent's income tax return for the decedent's last taxable year or such later date specified in regulations prescribed by the secretary of the treasury.[96] Any person required to furnish such information is subject to a penalty of $10,000 for each failure to do so.[97] Any person who must report to the IRS the receipt by a decedent within three years of death of appreciated property valued in excess of $25,000 within three years of death and who fails to do so is liable for a penalty of $500 for the failure to report such information to the IRS.[98] A penalty of $50 is imposed for each failure to report such information to a beneficiary.[99] No penalty is imposed with respect to any failure that is due to reasonable cause.[100] If any failure to report to the IRS or a beneficiary is due to intentional disregard of the rules, then the penalty is 5 percent of the fair market value of the property for which reporting was required, determined at the date of the decedent's death (for property passing at death) or determined at the time of gift (for a lifetime gift).[101]

Lifetime Gifts

For lifetime gifts required to be reported on a gift tax return for the calendar year, the donor must provide each donee (property recipients) listed on the return: (1) the name, address, and phone number of the person required to make such a return, and (2) the information specified in the gift tax return with respect to property received by the donee.[102] The written statement must be furnished to the donee not later than 30 days after the date that the gift tax return is filed.[103]

OTHER CHANGES UNDER THE 2001 ACT AND SUNSET PROVISION

Other changes under the 2001 Act, but less significant as far as their impact on estate planning is concerned, are those with respect to the repeal of certain restrictions on where land is located with respect to conservation easements under I.R.C. Section 2031(c)(8)(A)(i); various amendments to the generation-skipping transfer tax under I.R.C. Sections 2632 and 2642;[104] amendments to I.R.C. Section 6166 for the installment payment of federal estate tax;[105] and waiver of statute of limitations for taxes on certain farm valuations.

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[95] I.R.C. § 6018(e).
[96] I.R.C. § 6075(a).
[97] I.R.C. § 6716(a).
[98] I.R.C. § 6716(a).
[99] I.R.C. § 6716(b).
[100] I.R.C. § 6716(c).
[101] I.R.C. § 6716(d).
[102] I.R.C. § 6019(b).
[103] I.R.C. § 6019(b) flush language.
[104] *See* discussion in Chapter 8.
[105] *See* discussion in Chapter 12.

The 2001 Act is subject to a sunset provision. In this regard, all provisions of, and amendments made by, the 2001 Act do not apply to estates of decedents dying, gifts made, or generation-skipping transfers, after December 31, 2010. Whether the sunset provision of the 2001 Act is set aside by future legislation remains to be seen. Based on this author's more than 30 years of estate planning experience, it is unlikely that the federal estate and generation-skipping transfer tax will be repealed after December 31, 2009, as scheduled. The sunset provision provides that all provisions of, and amendments made by, the 2001 Act will not apply to estates of decedents dying, gifts made, or generation-skipping transfers, after December 31, 2010.[106] In effect, the Code of 1986 will apply as if the provisions and amendments made by the 2001 Act had never been enacted.[107]

CONTINUING NEED FOR ESTATE PLANNING

Prior to the enactment by Congress of TRA '76, estate planning was relatively simple and straightforward. The family attorney was usually quite adept at designing a will and trust to administer and distribute an estate owner's property at death. Furthermore, the preparation of wills used to be a loss leader—the theory being that such client services led to other business, including a profitable fee for probating the testator's estate.[108] The tax laws were relatively understandable and contained many loopholes; creative and ingenious planning opportunities abounded.

However, with the promulgation of TRA '76, estate planning became complicated. The tax laws are no longer rational, and they are unnecessarily complex. It has become a real challenge for practitioners just to communicate the effect of particular estate, gift, and generation-skipping transfer tax provisions of the Code to estate owners. Today, the family attorney and accountant find themselves bewildered by estate planning as we have come to know it. Gone are the days of preparing a will as a loss leader for other more profitable legal services.

Estate Planning without Estate Tax

Some years ago, the National Association of Estate Planning Councils observed that nearly 5 percent of those persons who have estates to plan do any significant estate planning. Although many people perceive estate planning as dealing only with taxes and the purchase of life insurance, ample evidence suggests that most people need advice and guidance in the preservation and disposition of the estates they have created. Unfortunately, for many decades, estate owners have allowed tax planning to become the tail that wags the dog. Even if the federal estate tax and generation-skipping transfer taxes are, in fact, repealed in 2010, estate planning is still necessary. Trust planning for a surviving spouse will still be necessary to provide financial security and efficient management of assets, particularly for a surviving spouse who does not have a penchant for asset management. Divorces will still occur; children with special needs will still be born; protection for spendthrifts will still be necessary; trusts for education funds will still be desirable; cautionary advice will continue to be needed about the perils of abusive trust tax shelters; and business succession planning will still be of vital concern to business owners. People will still need to know their planning options regarding a variety of needs and objectives to ensure family wealth

[106] The 2001 Act, Sec. 901(a)(2).

[107] The 2001 Act, Sec. 901(b).

[108] Nicholas U. Sommerfeld, "Techniques That Can Help Professionals Develop A More Successful Practice," 10 *Estate Planning* 330, 333 (November 1983).

preservation. The revocable living trust can effectively serve as the primary instrument for the lifetime management of a person's assets and for the orderly and cost effective disposition of those assets upon the death of the trustor. To this end, will and trust planning will continue for totally nontaxable reasons.

In retrospect, starting with TRA '76 all tax laws enacted by Congress have brought unprecedented complexity into the estate and gift tax planning arena. Today practitioners and estate owners are faced with new challenges as a direct result of post-TRA '76 legislation, case law, IRS rulings, and regulations. Thus, in view of all of the tax law changes that have occurred, anyone who is seriously interested in keeping together and transferring to their loved ones, with the least amount of emotional trauma and financial cost, that which they have worked so hard to create needs estate planning. With the exemption amount scheduled to increase to $3.5 million in 2009, persons whose estates are valued at less than $3.5 million will tend to dismiss the value and need for comprehensive estate planning, since such an amount will not be subject to federal estate tax. Yet, $3.5 million represents a substantial estate that deserves to be afforded every nontax estate planning strategy available to ensure its preservation.

The need for comprehensive and effective estate planning is greater than ever. Some married estate owners will say, "If my wife and I can each leave an amount equal to the federal estate tax exemption amount free of estate tax to our children, I don't have anything to worry about because our total estate is not worth two times the exemption amount." Or, "Since I can leave the entire value of my estate to my spouse estate tax free, why should I worry about planning my estate?" The reality is that, even for smaller estates, estate planning is essential to lifetime financial security.[109] In view of the 2001 Act, wills and trusts should be designed to accommodate the three phases of the 2001 Act, namely, "rate reduction/exclusion increase, repeal, and revival."[110]

Following the enactment by Congress of ERTA '81, estate-planning inertia befell many estate owners. Like untreated depression, similar inertia will challenge estate owners in view of the 2001 Act. As the exemption amount increases, estate owners will have more to protect—not necessarily from federal estate and state death tax but for the economic, social, educational, health care, and special needs of beneficiaries. Marital deduction trust plan-

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[109] *See* Jonathan G. Blattmachr, Georgiana J. Slade, and Bridget J. Crawford, "Selected Estate Planning Strategies for Persons With Less Than $3 Million," *Estate Planning* 243 (July 1999).

[110] Sidney Kess and Lee Slavutin, "Planning Techniques and Tips: Important Considerations in Drafting the Will," *Estate Planning Review* in 4 *Financial and Estate Planning* 60, 62, Commerce Clearing House, Inc., Chicago, Ill (July 19, 2001); for additional reading, *see* Ronald D. Aucutt, "An A-to-Z 'To Do' List Following EGTRRA," 28 *Estate Planning* 606 (December 2001); Jonathan G. Blattmachr and Lauren Y. Detzel, "Estate Planning Changes in the 2001 Tax Act—More Than You Can Count," 95 *Journal of Taxation* 74 (August 2001); David Frees, "Marketing Estate Planning After The 2001 Act: Interview With David Frees," interview by editors of Commerce Clearing House, Inc., *Estate Planning Review* in 4 *Financial and Estate Planning*, issue 521 (August 20, 2001): 89; James F. Gulecas and Alan S. Gassman, "The Economic Growth and Tax Relief Reconciliation Act of 2001: Practical Estate Planning," 15 *Practical Tax Lawyer.* 35 (Summer 2001); Philip Marcovici, Teresa Lewis, Marnin J. Michaels, Victoria A. Dalmas and Christine Hsieh-Kammerlander, "New U.S. Tax Act: Dramatic Consequences for Estate, Gift, GST Regime in the Foreign Context: Part 1," 26 *Estate Planner's Alert* 2 (September 2001), Part 2 (October 2001) 2 in Research Institute of America *Estate Planning & Taxation Coordinator*; Charles F. Newlin and Andrea C. Chomakos, "The 2001 Tax Act: Uncharted Waters for Estate Planners," 15 *Probate & Property* 32 (September-October 2001); Northern Trust Company, "The Economic Growth and Tax Relief Reconciliation Act of 2001," in 3 *Financial and Estate Planning*, Commerce Clearing House, Chicago, IL, ¶ 32,351, at 27,171; Sanford J. Schlesinger, "Estate and Gift Tax—Update 2001," *Estate Planning Review*, in 4 *Financial and Estate Planning* 1, Commerce Clearing House, Chicago, IL (January 22, 2002); Edward Spacapan, Jr., "2001 Tax Act Substantially Improve Retirement and Savings Plans," 29 *Estate Planning* 16 (January 2002).

ning to minimize estate tax, for example, may no longer be necessary for many estate owners; nevertheless, these same estate owners may be duly concerned about providing a surviving spouse with financial security and protection of assets from mismanagement. Trusts for a surviving spouse which bear some resemblance to marital and nonmarital deduction planning trusts may still be employed but not necessarily for the purposes of minimizing or entirely eliminating federal estate tax in both the decedent spouse's and surviving spouse's respective estates. Or an estate owner may be concerned about the impact of divorce on the ultimate disposition of his or her estate in the event of remarriage and how such an event, such as divorce, might affect his or her children. Likewise, an estate owner may be concerned about the potential for a child to divorce his or her spouse and the impact that such a marriage termination would have on the share of the estate owner's estate in the hands of the divorcing child. TRA '76 and all of the tax laws enacted since TRA '76 demand that anyone with an estate make a financial and time investment in properly planning his or her estate.

Furthermore, even if under the 2001 Act the estate and generation-skipping transfer taxes are permanently repealed, the gift tax remains in effect. Moreover, after December 31, 2009, except as provided in Treasury Regulations, the transfer of property to a trust will be treated as a taxable gift, unless the trust is wholly owned by the donor or the donor's spouse under the grantor trust provisions of I.R.C. Sections 671 through 678.[111] Conceivably, a transfer of property in trust for charitable purposes could reduce the donor's available gift tax exemption amount, if the trust is not wholly owned by the donor or the donor's spouse.[112] As a general rule, a charitable remainder trust is not a grantor trust; but a revocable living trust is a grantor trust.

Definition of an Estate

At the risk of oversimplification, all of a person's property or interests in property comprises his or her gross estate.[113] Legally speaking, an estate is the degree, quantity, nature, and extent of a person's interest in real and personal property.[114] Thus, in the broadest terms, anyone who owns property or has an interest in property has an estate.

Property Included in the Gross Estate

As a general rule, the gross estate includes the value of all property to the extent of the decedent's interest in the property at the time of death.[115] It is the decedent's possession of the economic benefits of property that determines whether the value of the property is included in the decedent's gross estate.[116] Accordingly, the gross estate includes property owned by a decedent at the time of death which can be transferred in accordance with the terms of a will, under the provisions of a revocable living trust, by right of survivorship, by beneficiary designation in a contract, or by the law of intestate distribution (i.e., to die

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[111] I.R.C. § 2511(c).

[112] *See* Commerce Clearing House, ed., *2001 Tax Legislation: Law, Explanation and Analysis (Economic Growth and Tax Relief Reconciliation Act of 2001)*, Commerce Clearing House, Chicago, IL, 2001, Practical Analysis at 105 (hereafter CCH, *2001 Tax Legislation: Law, Explanation and Analysis*).

[113] I.R.C. §§ 2031 and 2033.

[114] Henry Campbell Black, M.A., *Black's Law Dictionary* (West Publishing, 5th ed. 1979), 490 (hereafter Black, *Black's Law Dictionary*).

[115] I.R.C. § 2033.

[116] *Burnet v. Wells*, 289 U.S. 670, 678 (1933); *Helvering v. Safe Deposit & Trust Co. of Baltimore*, 316 U.S. 56, 56 n. 1 (1942).

without a will).[117] Hence, a decedent's estate may include probate assets (probate estate), as well as property passing to a decedent's beneficiaries outside of probate (nonprobate estate).

The gross estate may also include other property interests that the decedent did not own at death. Such interests may include: dower or courtesy interests (I.R.C. Section 2034); transfers of property for insufficient consideration (I.R.C. Section 2043); qualified terminable interest property (QTIP) for which the marital deduction was previously claimed (I.R.C. Section 2044); prior interests (I.R.C. Section 2045); disclaimed property (I.R.C. Section 2046); income in respect of a decedent (IRD) (I.R.C. Section 691); gifts of property made within three years of death (I.R.C. Section 2035); transfers of property with retained life estate (I.R.C. Section 2036); transfers of property taking effect at death (I.R.C. Section 2037); revocable transfers of property (I.R.C. Section 2038); property subject to a grantor retained annuity or income trust (I.R.C. Section 2702); property subject to a general power of appointment (I.R.C. Section 2041); and annuities, including retirement plan benefits (I.R.C. Section 2039). The gross estate does not include property that the decedent owned at death that could not be transferred by a will or by intestate distribution, such as a life estate created by another person.

Transfer Taxes Imposed upon the Estate

The value of a decedent's estate may be subject to federal estate tax and state death taxes (transfer taxes).[118] For both tax and nontax planning purposes, the federal estate tax exemption amount may be used to determine whether a person's estate is small, medium, or large. An estate valued at the federal estate tax exemption amount or less may be a small estate; an estate valued in excess of the federal estate tax exemption amount, but less than two times the federal estate tax exemption amount, may be a medium-size estate; and an estate valued in excess of two times the federal estate tax exemption amount may be a large estate. However, a husband and wife might each have a small to medium-size estate; but, combined, they might have one large estate for the survivor of them. Regardless of value, effective and efficient estate planning begins and ends with the correct form of property ownership and the proper beneficiary designations of contract benefits.

UNDERSTANDING THE FIVE ESTATES IN ESTATE PLANNING

A person's estate consists of the *gross estate*, *adjusted gross estate* (AGE), and *taxable estate*. The gross estate, however, consists of assets that compose the *probate estate* and the *nonprobate estate*. Certain deductions are allowed to be taken from the value of the *gross estate* to determine the value of the AGE, which, in turn, leads to determining the value of the *taxable estate*. Taxes levied on the taxable estate can be reduced by certain tax credits. Thus, five different estates must be taken into account in the estate planning process.

Developing an effective estate plan depends on the practitioner's and estate owner's ability to understand the interrelationship of the probate and nonprobate estates to the gross estate, together with their relation to the AGE, and the taxable estate. Remember, the gross estate includes the decedent's probate estate and nonprobate estate.

Probate Estate

What is the probate estate? A person's probate estate consists of all property passing to beneficiaries under the terms of a will; or, if the estate owner dies without a will (to die *intestate*), the probate estate includes property passing to the decedent's heirs by state law of

117 Black, *Black's Law Dictionary*, 490.

118 I.R.C. § 2001(a).

intestate distribution. Probate property includes all property a person owns individually as tenants in common and, in certain cases, as community property. Any property that is payable to or distributable to the decedent's estate at death is part of the decedent's probate estate. For example, an insured decedent's estate may have been designated beneficiary of life insurance proceeds. In such case, the value of the life insurance proceeds is includable in the decedent's gross estate for purposes of the federal estate tax and is also part of the decedent's probate estate. Accordingly, the life insurance proceeds are subject to the court-supervised procedure known as *probate* before the proceeds are distributable to the decedent's beneficiaries under a will or, if the decedent died without a will, to the decedent's heirs under state law of intestate succession.

Example

Neville B. Johnson is the owner of a life insurance policy insuring his life for $200,000. When his insurance agent asked him to whom he wanted the insurance proceeds paid upon his death, Neville replied, "To my estate." Accordingly, the insurance agent wrote on the insurance application in the space provided for designating the beneficiary the following: "Beneficiary: to the estate of the insured Neville B. Johnson." Thus, in the event of Neville's death, and assuming this beneficiary designation is not revoked prior to Neville's death, the insurance company will pay the insurance proceeds "to the estate of Neville B. Johnson." Accordingly, the life insurance proceeds will become part of Neville's probate estate and will be subject to the court-supervised process known as probate.

Property Directed to Decedent's Estate

Any property that is payable or distributable to the decedent's estate is part of the probate estate (e.g., payable-on-death (POD) bank accounts, qualified plan benefits, any type of contractual benefit wherein the decedent's estate can be designated beneficiary). Remember: if the decedent's estate is the beneficiary of any property, then the value of such property is part of the decedent's probate estate; if property owned by the decedent passes to a beneficiary by the terms of the decedent's will, the value of the property is part of the decedent's probate estate; and, if the decedent dies without a will, the value of property in the decedent's own individual name or property that is payable to the decedent's estate is part of the probate estate and passes to the decedent's heirs under the laws of intestate distribution.

Community Property

If property is owned by a husband and wife as community property, the surviving spouse's one-half interest may or may not be subject to probate, depending on state community property law. This may be the case if the spouses entered into a community property agreement that contains a survivorship provision. Even if the decedent spouse's one-half interest in the community property need not be probated because it passes outright to the surviving spouse, it may be necessary for a probate court to determine that the property is, in fact, community property. Absent such a determination, a title company may be unwilling to insure the title to real property.

Necessity of Probate Estate

Along with the correct form of property ownership and beneficiary designation of contract benefits, the probate estate is the next most important consideration in the estate planning process. This is particularly true when a revocable living trust is not used in the estate plan. A decedent's will cannot carry out its purpose unless there is a probate estate. Generally, a will cannot distribute property that is not part of the probate estate.

For example, if the decedent spouse owns property with the other spouse as joint tenants with right of survivorship (JTWROS), or the surviving spouse is designated beneficiary of the decedent spouse's contract benefits (e.g., qualified plan benefits, 401(k) plans, Simplified Employee Pensions (SEP), Individual Retirement Accounts (IRA), Keogh plans, qualified or nonqualified deferred compensation plans, salary continuation benefits, survivor benefits, individual life insurance, group term life insurance, and so forth), then, upon the decedent spouse's death, those assets pass directly to the surviving spouse and not by the terms of the decedent spouse's will. Hence, trusts for the surviving spouse, minor and adult children, or beneficiaries with special needs cannot be funded. Likewise, special bequests not in trust to specific beneficiaries, such as individuals and charities, cannot be funded.

Pour-Over Will

The only exception to this rule is a pour-over will that directs property in the decedent's probate estate to be distributed under the terms of a revocable living trust (RLT) created before a person's death. Such assets may be subject to a probate proceeding before being distributed to the RLT. Under the small estate statutes of most states, depending on the value of such probate estate assets, a formal probate proceeding may or may not be required to clear title to such assets before being distributed to the RLT. In other words, the will recognizes the existence of the RLT and provides that any property discovered after the decedent's death which was not conveyed to the trustee of the RLT before the decedent's death is to be distributed (*poured over*) to the RLT and administered according to the terms of the RLT. Property conveyed (titled in the name of the RLT trustee) to the RLT during the decedent's lifetime is not part of the decedent's probate estate because legal title or ownership of the property vests by law in the trustee, thereby obviating the need to clear title to such property in a probate proceeding.

Nonprobate Estate

What is the nonprobate estate? Generally, all property passing outside the decedent's will is not subject to the probate process. Accordingly, such property is not part of the decedent's probate estate.

Life Insurance

Life insurance proceeds paid to a designated beneficiary other than the insured decedent's estate are included in the nonprobate estate. In other words, if the life insurance proceeds are payable to a named beneficiary other than the decedent's estate (e.g., a surviving spouse, to any person, or to the trustee of a trust), then, such proceeds are not part of the probate estate. Rather, such proceeds are part of the decedent's nonprobate estate. However, if the insured decedent possessed an incidents of ownership in the life insurance policy at death, then, the proceeds are includable in the value of the decedent's gross estate.

Property Received by Right of Survivorship

Property owned by the decedent as JTWROS (including tenancy by the entirety) with any other person, whether such person is related or unrelated to the decedent or is the decedent's spouse, is includable in the value of the decedent's gross estate and is part of the decedent's nonprobate estate. Perhaps the most popular and celebrated reason for joint ownership with right of survivorship is the avoidance of probate. Since the surviving cotenant (joint owner) acquires ownership of the entire property automatically by right of survivorship upon the death of the other co-tenant, the decedent co-tenant's interest in the property is not part of the decedent's court-administered probate estate. Likewise, out-of-state probate (ancillary probate) can be avoided on property located in another state that is owned as JTWROS. Finally, the absence of probate may also prevent publicity and ensure privacy about the nature and value of the property passing to the surviving co-tenant.

Bank Trust Accounts and Contract Benefits

Bank accounts and contract benefits may be part of the decedent's nonprobate estate. Bank accounts held *in trust for* (so-called Totten trust) a person who survives the decedent are included in the nonprobate estate. Qualified retirement plan benefits, including IRAs, Keogh plans and 401(k) plans, SEPs, qualified and nonqualified deferred compensation plan benefits, salary continuation benefits, annuity contracts, and individual and group life insurance proceeds payable to a designated beneficiary other than the decedent's estate are part of the nonprobate estate.

Other Nonprobate Property

Other property interests included in the nonprobate estate are: property gifted by the estate owner during lifetime, the value of which may be included in the decedent's gross estate solely for computing the federal estate tax, and property interests given in trust by someone else to the decedent which pass upon the decedent's death by a general power of appointment exercised by the decedent in favor of another beneficiary. However, if the decedent exercised a general power of appointment over such property in favor of the decedent's estate, then such property is included in the decedent's probate estate. Finally, property conveyed to a revocable (or irrevocable) living trust by the decedent before death is not subject to probate. Accordingly, such property may be includable in the value of the decedent's gross estate and is part of the decedent's nonprobate estate. Not only is such property not subject to probate but the trustor can also control the ultimate disposition of the property; whereas, if the decedent had continued to own the property as JTWROS, or if the property passed by beneficiary designation, then trusts would not be funded with the property as they could be if the property were distributable under the provisions of a RLT.

Coordination of Beneficiaries with Property Ownership

Regardless of whether transfer taxes are of concern to the estate owner, distributions of property to a surviving spouse and to other beneficiaries of the decedent require careful coordination. In second marriage situations, aside from the matter of taxes, the more important objective may be to provide for the surviving spouse's financial needs while ensuring that, upon the surviving spouse's subsequent death, the property set aside for the surviving spouse's financial support will pass to the first decedent spouse's children by a former marriage. Alternatively, one spouse may be at least a generation (25 years or more) older than the other spouse; the older spouse may have (by a former marriage) adult children who are older than the present younger spouse and minor children of the present marriage. In such a situation, the older spouse may want to leave one-eighth of his or her estate to each of the four adult children, one-eighth to each of the two minor children, and one-quarter to his or her present spouse with the assurance that, upon the subsequent death of the surviving spouse, at least one-half of that spouse's one-quarter share of the first decedent spouse's estate will be distributable to the minor children of the marriage. In such a case, special attention must be given to the surviving spouse's right under state law to elect against the decedent spouse's estate. Many states provide that, when a spouse dies with surviving children of the present marriage, the surviving spouse is entitled to at least one-half of the decedent spouse's estate (in some states, the elective share is one-third). Thus, leaving the surviving spouse a one-quarter interest in the decedent spouse's estate may not satisfy a surviving spouse's right to elect against the decedent spouse's estate under state law.

Situations such as these are increasingly prevalent among senior citizens who have adult children by former divorced or deceased spouses. Closely associated with these considerations may be the matter of transfer taxes as they relate to both spouses' estates. The proper use of marital and nonmarital deduction estate planning can enable the estate owner to designate the ultimate beneficiaries of the estate while providing lifetime financial security for the surviving spouse and still minimize or eliminate transfer taxes.

Probate and Nonprobate Estate Assets

Strict attention must be paid to the assets composing the first decedent spouse's probate and nonprobate estates in order to achieve effective results from marital and nonmarital deduction planning. In order to determine whether and to what extent the marital deduction should be used, property that will pass to the surviving spouse under the first decedent spouse's will (probate estate), as well as outside the will (nonprobate estate), must be identified. Furthermore, in determining the amount of property necessary to provide for the surviving spouse's financial support and the approximate value of the surviving spouse's resulting taxable estate, it is important to consider the value of property the surviving spouse may have available which is not includable in the first decedent spouse's gross estate and which will not be includable in the surviving spouse's estate (e.g., life insurance proceeds on the life of the first decedent spouse from a policy owned by and payable to an irrevocable trust that provides a life estate for the surviving spouse).

Gross Estate

As previously discussed, a decedent's gross estate includes the value, at the time of death, of all property, real or personal, tangible or intangible, wherever situated.[119] In this regard, specific types of property come to mind, such as the family home, stocks, bonds, cash, jewelry, automobiles, and so forth, as being includable in the gross estate. Such property certainly is includable, but other considerations identified as interests in property are also includable in the gross estate. These considerations are: I.R.C. Sections 2033 and 2034 interests in property; I.R.C. Sections 2035, 2036, 2037, and 2038 transfers during lifetime; I.R.C. Sections 2039, 2040, 2041, and 2042 specific properties; I.R.C. Section 2043 lifetime transfers for insufficient consideration; I.R.C. Sections 2044 and 2045 preexisting transfers or interests; and I.R.C. Section 2046 disclaimers.

Adjusted Gross Estate

The value of the decedent's adjusted gross estate (AGE) is extremely important in qualifying the estate for the following tax-favored benefits: redemption of stock in a closely-held corporation under I.R.C. Section 303; special use valuation under I.R.C. Section 2032A; qualified family-owned business interest deduction under I.R.C. Section 2057;[120] determination of the allowable marital deduction under I.R.C. Section 2056 for wills and trusts effected before September 12, 1981, containing maximum marital deduction formula provisions; and deferred installment payment of estate taxes under I.R.C. Section 6166.

The AGE is determined by subtracting from the value of the gross estate those deductions allowable under I.R.C. Sections 2053 and 2054. Deductions from the value of the gross

[119] I.R.C. § 2031.

[120] The qualified family-owned business interest deduction is repealed after December 31, 2003, by I.R.C. § 2057(j).

estate are generally of three types: those allowed for costs actually incurred (e.g., administration fees, funeral costs, and so forth); those that reduce to its net fair market value the value of property (e.g., mortgages); and those bona fide losses incurred through casualty or theft.

Taxable Estate

Two possible definitions may be used to describe the taxable estate, depending on one's point of view. On the one hand, the Code and Treasury Regulations (Regulations) provide that the taxable estate of a decedent who was a citizen or resident of the United States at the time of death is determined by subtracting from the total value of the decedent's gross estate the total amount of the deductions allowable by I.R.C. Sections 2053-2056. As previously mentioned, these deductions are:[121] funeral and administration expenses and claims against the estate (including certain taxes and charitable pledges);[122] losses from casualty or theft during the administration of the estate;[123] charitable transfers;[124] and the estate tax marital deduction.[125]

On the other hand, the taxable estate may be defined as the adjusted gross estate, less any charitable and marital deductions available to the decedent's estate. In fact, computing the federal estate tax is a six-step process:

1. Value of the gross estate is determined;
2. AGE is determined;
3. Depending on whether the charitable or the marital deduction applies, the taxable estate is determined;
4. Tentative tax base is determined by adding to the taxable estate any adjusted taxable gifts. Adjusted taxable gifts are the total amount of taxable gifts made by the decedent after December 31, 1976, other than charitable gifts, gifts that are includable in the value of the decedent's gross estate, and gifts to a spouse after 1981.[126] Gifts qualifying for the gift tax annual exclusion are not includable as adjusted taxable gifts in the decedent's taxable estate because they are not taxable gifts. Thus, a decedent's adjusted taxable gifts do not include the one-half value of gifts made by the decedent attributable to his or her spouse because of gift-splitting, provided the one-half value per gift does not exceed the gift tax annual exclusion amount.[127] Apart from these exceptions, even if no gift tax was paid on a gift because the unified credit was used to offset any gift tax otherwise due, the gift is still considered a taxable gift. For this reason, the value of the gift must be added to the taxable estate as a taxable gift;
5. Tentative tax is computed on the tentative tax base;
6. Certain allowable tax credits are subtracted from the tentative tax to arrive at the net federal estate tax due.

[121] I.R.C. § 2051; Treas. Reg. § 20.2051-1.
[122] I.R.C. § 2053; Treas. Reg. §§ 20.2053-1 through 20.2053-10.
[123] I.R.C. § 2054; Treas. Reg. § 20.2054-1.
[124] I.R.C. § 2055; Treas. Reg. §§ 20.2055-1 through 20.2055-5; § 24.1.
[125] I.R.C. § 2056; Treas. Reg. §§ 20.2056(a)-1 through 20.2056(e)-3; 22.2056-1.
[126] I.R.C. §§ 2001(b); 2503(a); 2522(a); and 2523(a).
[127] I.R.C. § 2503(b).

EFFECTIVE ESTATE PLANNING DEFINED

Estate planning is a branch of the law[128] that involves the design and implementation of a written plan for the lifetime and testamentary management of a person's estate. Effective estate planning depends upon a careful examination of the estate owner's assets. In this regard, are the assets income producing or nonincome producing? How will the assets be managed for the estate owner's benefit during his or her lifetime in the event of physical or mental incapacity? How will the assets be transferred at death? What are the needs of the estate owner's beneficiaries? For the estate owner, these and many other questions will be asked and answered for the fist time during the fact-finding process.

A written estate plan is to an attorney who designs and prepares the legal documents required to implement a person's estate plan what an architect's blueprints are to the contractor constructing a building. In other words, a formal written plan is necessary to guide the person responsible for building the end product; namely, the legal documents required to implement and carry out the estate plan. Contrary to popular belief, a will and trust by themselves are not an estate plan. These are only legal documents that carry out a person's estate plan. Unless the issues of property ownership and beneficiary designations of contract benefits are properly coordinated, the will and trust may not carry out a person's estate plan as intended. Accordingly, an estate plan is an indispensable formal written report that describes the operation of a person's present estate plan and offers recommendations for implementing a person's estate planning goals and objectives.

Properly designed, prepared, and executed legal documents are required to implement a well-designed estate plan. The primary operative documents are the last will and testament (will) and trust (testamentary or living trust). A testamentary trust may either be included in the will or may be a separate document. A living (*inter vivos)* trust, whether revocable or irrevocable, is never part of the will.

In addition, business agreements and other legal documents may supplement the will and trust. Such agreements and documents may include a buy-sell agreement or stock-redemption agreement, a living will (directive to physicians), a general or special durable power of attorney, and a durable power of attorney for health care.

Finally, conveyance documents may be needed to supplement the will and trust. These documents may include deeds, an assignment of contract, an assignment of lease, an assignment of personal property, an assignment of installment note, an assignment of stock and stock power, and a memorandum of trust. Other specially designed conveyance documents may be required, depending on the assets composing the estate and the estate owner's objectives.

Estate Planning and Tax Law

Of all the areas of tax law, estate planning is one of the most complex. For example, of all tax returns filed, the Form 706 has the highest probability of audit at the rate of approximately 20 percent, which is almost ten times the audit rate of an income tax return. For estates valued in excess of $1 million, the audit rate exceeds 50 percent. Faced with these audit probabilities, it is critically important that Form 706 be prepared carefully and correctly so as to minimize or entirely avoid an audit and to prevent assessment of tax deficiencies and penalties, even if the Form 706 is audited. A well-planned estate, coupled with a correctly prepared Form 706, greatly reduce the odds that the decedent estate owner's Form 706 will be audited.

To be a good estate planner, the practitioner needs to know how to correctly complete Form 706; conversely, to correctly complete Form 706, the practitioner must be a good estate planner. In order to complete the Form 706 correctly, the practitioner must possess not

[128] Black, *Black's Law Dictionary*, 493.

only knowledge of relevant Code provisions but also knowledge and understanding of the law of wills, trusts, life insurance, forms of property ownership, interests in property, and how these areas of the law are affected by income, estate, and gift taxes. Just to complete the first three pages of Form 706, the practitioner must thoroughly understand twenty-six essential areas of the federal tax system as embodied in Subtitle B of the Internal Revenue Code. Throughout this book, "Ask Your Attorney" questions and "Answers" are designed to assist the reader in determining whether his or her attorney is qualified to practice estate planning.

Purposes of Estate Planning

As a general rule, estate planning has at least three purposes: (1) eliminate an unnecessary court-supervised financial guardianship (conservatorship) of the estate owner's financial affairs during lifetime in the event of physical or mental incapacity; (2) carry out the estate owner's wishes and directions regarding the transfer of property to intended beneficiaries in the event of death; and (3) accomplish these objectives at a minimum financial cost and with the least amount of emotional distress.

Effective estate planning should not be limited strictly to tax considerations. In other words, the matter of taxes should not become the tail that wags the dog in the process of carrying out the purposes of estate planning. The estate owner's nontax estate planning objectives should be considered before tax-planning objectives. The tax impact of those objectives should then be compared. If the tax impact on nontax objectives is acceptable to the estate owner, fine; if not compatible, then the estate owner's adviser should present and recommend alternate planning arrangements closest to satisfying those objectives.

Lifetime Management Plan

A comprehensive estate plan includes a lifetime estate management plan that addresses the issue of how a person's estate is to be managed for the estate owner's benefit in the event of physical or mental incapacity. In this regard, if the estate owner does not have a plan in the event of physical or mental incapacity, a proper court of jurisdiction will appoint a guardian or conservator to manage the estate owner's personal and financial affairs. On the other hand, the estate owner may choose not to involve the courts, in which case only the following four options are available for the protection and management of property and financial affairs: (1) own property jointly with right of survivorship with another person; (2) designate an immediate family member or close trusted friend as attorney-in-fact under a durable general or special power of attorney; (3) create a funded revocable (or irrevocable) living trust; or (4) implement a combination of these options. In discussing each of these options, a qualified practitioner will identify a soft spot in the estate owner's present estate plan where improvement may be necessary or, conversely, identify a subject about which the estate owner wants to know more. In this regard, the practitioner should provide the estate owner with accurate, objective information that he or she may use to make an intelligent decision about his or her overall estate planning.

Plan to Transfer Property at Death

A comprehensive estate plan must also include a plan for the transfer and management of a person's estate in the event of death by identifying the intended beneficiaries and the manner in which property is distributable to them. Each beneficiary's age, maturity, educational needs, medical requirements, social and vocational opportunities, present financial status, and physical and emotional needs must be recognized in view of the methods that may be employed to transfer property to him or her. In this regard, only five ways exist to transfer property at the estate owner's death:

1. Last will and testament (which may or may not incorporate a testamentary trust);
2. Contract (e.g., a life insurance policy). Designation of a beneficiary in a life insurance contract takes precedence over any beneficiary of the same insurance proceeds named in the decedent's will. The sole exception to this rule is when the estate of the insured decedent is designated primary beneficiary of the insurance proceeds. By such a designation, the insurance proceeds are payable to the insured decedent's estate (or trust estate, in the case of a living trust) and are distributable, along with all of the decedent's other assets, to the beneficiaries named under the decedent's will (or living trust). This same rule applies with regard to an IRA, SEP, 401(k) plan, Keogh plan, salary continuation plan, deferred compensation (qualified and nonqualified), qualified retirement plan benefits, group life insurance, or any other contract benefit;
3. Survivorship [i.e., JTWROS; tenants by the entirety (with right of survivorship); tenants in common with right of survivorship; survivorship in a community property agreement];
4. Operation of law [i.e., dying without a will (intestate succession)]; and
5. Revocable or irrevocable living trust created and funded during the estate owner's lifetime. *Funded* means that the estate owner's property (assets) is properly registered (titled) in the name of the trustee of the living trust.

Observation

A grantor retained annuity trust (GRAT), a grantor retained unitrust (GRUT), and a qualified personal residence trust (QPRT) are irrevocable living trusts that may be used to transfer the decedent grantor's property to his or her intended beneficiaries.

MISCONCEPTIONS ABOUT ESTATE PLANNING

Many estate owners do not understand the process of estate planning. This is due in large part to the inability of the practitioner to communicate to the estate owner exactly what is involved in the estate planning process. Further, because estate planning involves more than just effecting a will or trust, many estate owners have misconceptions about estate planning. These misconceptions, when not addressed by practitioners, are some of the primary reasons why so many so-called estate plans fail to operate as the estate owners intended.

Misconception: Will and Trust Are an Estate Plan

One misconception is that a will and trust constitute an estate plan. As previously discussed, these legal documents only carry out the decedent's estate plan. Unless the practitioner conducts a thorough fact-finding interview and designs a formal, written estate plan based on the estate owner's goals and objectives, the resulting estate plan will look much like a Rube Goldberg cartoon—the end result achieved solely by chance.

Misconception: Probate and Taxes Are Related

Another misconception is that, if estate taxes (federal and state) are not imposed on an estate, probate of the estate is unnecessary. Of course, transfer taxes and probate have absolutely nothing to do with one another. They are completely unrelated matters. On the one hand, as a general rule, if estate taxes are due, property comprising the probate estate will not be released from the probate process to be distributed by the personal representative (or administrator, if the decedent dies intestate) to those beneficiaries (or heirs) of the decedent entitled to receive such property until the taxes are paid or arrangements have been made to pay the taxes. On the other hand, an estate may be subject to probate when income or transfer taxes are not imposed.

Misconception: Having a Will Eliminates Probate

Many people also operate under the misconception that, if a person has a will, probate is unnecessary. Having a will does not guarantee that probate can be avoided. The truth is that a person's estate may be probated whether or not a will is involved. If the decedent's estate includes probate estate property, probate may be required. Generally, the value of such property determines whether a formal probate proceeding is required or if the property can be administered under a state's small estate statute.

Misconception: Probate Is Determined by Federal Estate Tax Exemption Amount

A fourth misconception is that, if the value of a person's estate is less than the federal estate tax exemption amount, probate is unnecessary. The federal estate tax exemption amount relates to federal estate tax; it has nothing to do with whether a decedent's estate is required to be probated. Also, the federal estate tax exemption amount should not be used as a guide to determine whether a person's estate is large enough to warrant the use of a revocable living trust. The use of a revocable living trust should not be determined by the value for federal estate tax purposes of a person's estate.

COMMON MISTAKES MADE IN ESTATE PLANNING

Misconceptions about estate planning contribute to mistakes made in estate planning. Since 1979, as a fee-paid specialist in estate/gift taxation and planning, this author has yet to review in the initial get-acquainted interview a person's existing will and trust that would carry out the person's estate plan as intended. Many reasons exist for this truism; yet, the majority of the reasons can be attributed to often-repeated common mistakes.

Updating

The most frequent mistake people make is not updating their estate plans, wills, or trusts. People simply do not realize that their estate plans are dynamic, rather than static. People forget that marriages and divorces; deaths and births; changes of domicile, residencies, or jobs; illnesses in families; changes in the tax laws; and other myriad factors influence estate plans. Often, modifications made to estate plans necessitate amendments to existing wills and trusts.

Incorrect Form of Property Ownership

Incorrect form of property ownership in relation to the terms of the estate owner's will and trust agreement can compromise the estate owner's intentions for how the property should pass to intended beneficiaries. Owning property as JTWROS is the single most common mistake that causes estate plans of married persons to fail. As previously mentioned, a will cannot distribute property that is owned by the decedent and another person as JTWROS. Likewise, a trust under a will, or as a separate legal document, cannot be funded when property is owned by two or more persons as JTWROS. Consequently, the estate tax marital deduction taken in the decedent spouse's gross estate may be more than necessary (overqualified marital deduction) to reduce or eliminate estate tax in relation to the decedent spouse's federal estate tax exemption amount; and the surviving spouse's estate may be subject to unnecessary estate tax because too much property received by right of survivorship is included in the surviving spouse's gross estate.

Incorrect Beneficiary Designations of Contract Benefits

Incorrect beneficiary designations of employer-provided contract benefits are another common mistake. Designating the wrong beneficiary of a contract benefit (e.g., qualified plan benefits, 401(k) plans, SEPs, IRAs, Keogh plans, nonqualified deferred compensation plans, salary continuation benefits, survivor benefits, group term life insurance) can have the same effect as owning property jointly with right of survivorship. In situations involving married persons, too much property may be eligible for the estate tax marital deduction in the estate of the first decedent spouse, resulting in overexposure of this property to estate tax in the estate of the surviving spouse. Moreover, the Service's new rules limit the circumstances under which a trust will qualify as a designated beneficiary for minimum distribution purposes of qualified retirement plan benefits, which, in turn, may cause unintended income tax consequences upon the death of a plan participant.[129]

Life Insurance Ownership

Life insurance is one of the most valuable assets available to the estate owner. Yet, its importance in providing liquidity and a source of funds for a variety of purposes is greatly misunderstood and disregarded. Mistakes are frequently made regarding the ownership and beneficiary designations of life insurance policies in relation to other assets composing a person's estate. Furthermore, violating the life insurance policy transfer-for-value rules can subject the beneficiary of the life insurance proceeds to unnecessary income tax.

Use of Investment Assets to Provide Estate Liquidity

Overreliance on investment property to provide liquidity in an estate is also a common mistake. It makes no sense to sell income-producing real property, long-term growth stocks, highly appreciated securities, or property that produces tax-free income just to pay transfer costs and estate administration expenses. The use of income-tax-free life insurance proceeds to provide needed liquidity may be more prudent. It would be the exception, rather than the rule, for a person to pay total premiums on a life insurance policy equal to the death proceeds. This is why life insurance proceeds are called "dollars for pennies apiece" or "discounted dollars."

Absence of Closely-Held Business Planning

Absence of planning for closely-held business interests accounts for many mistakes. Often the matter of preserving business ownership and continuity of management is not given adequate attention in the estate planning process. Such oversight in a family business operated as a sole proprietorship may cause the business to die with the owner. Moreover, many family-operated businesses fail to develop plans to mitigate divisiveness or promote equity of participation among family members or nonfamily key employees. Finally, many

[129] *See* discussion in Chapter 15.

an estate owner makes the mistake of not providing adequate operating funds for the daily operation of the business upon his or her death.

Numerous mistakes are made in the planning of buy-sell agreements. In view of I.R.C. Section 2703, particular attention must be paid to any buy-sell agreement entered into or substantially modified after October 8, 1990.[130] Despite the attention that must be paid to I.R.C. Section 2703 when a buy-sell agreement is contemplated, the following questions and concerns should also be addressed to avoid unnecessary mistakes:

- What method is used to determine the value of the business?
- Are provisions made to periodically adjust the value of the business?
- Are the terms and conditions for a lifetime purchase of a shareholder's business interest the same as those terms and conditions for purchase of the shareholder's interest in the event of death?
- Will a shareholder's interest in the business be acquired in the event of long-term disability? If yes, is the agreement funded with long-term disability insurance?
- To avoid costly mistakes that can arise when buy-sell agreements are funded with life insurance, consideration must be given to the identity of the beneficiary of the insurance proceeds; [i.e., whether the decedent-shareholder's estate (or surviving spouse) or the surviving shareholder is the beneficiary];
- The rules of attribution under I.R.C. Section 318 must be carefully observed in relation to the rules covering distributions in redemption of stock under I.R.C. Section 302. These sections of the Code are traps for the unsuspecting estate planner and business owner when lifetime redemptions of stock are contemplated;
- If an I.R.C. Section 303 stock redemption is contemplated under a stock-redemption arrangement, will the shareholder's interest in the shares to be redeemed be directly reduced by transfer taxes and funeral and administration expenses?

Selection of Fiduciaries

Mistakes are often made in the selection of a personal representative to administer a person's estate or in selecting a trustee to administer and manage the property in a trust. A will or trust cannot fail to operate for want of a personal representative or trustee, but it can fail to operate as the estate owner intended because the wrong fiduciary was chosen. Provision can be made in a will or trust agreement for the replacement of a fiduciary by the decedent's beneficiaries; or, absent their agreement, a proper court of jurisdiction can remove a fiduciary for cause or on the grounds cited in the will or trust agreement.

Unequivocally, the most important attributes of a good fiduciary are honesty and integrity. Acumen in business and investment matters is not absolutely essential to the question of whether an individual can be an effective fiduciary. This is because many of the tasks that a fiduciary is called upon to perform can be delegated to persons skilled in particular occupations. Other considerations in the selection of a fiduciary are whether: the trustee's interests might be adverse to the beneficiary's interests; the trustee will have the time and desire to administer the estate; the trustee will get along well with the beneficiary; and the trustee's interests as a beneficiary will be above the interests of any other beneficiary. To be a fiduciary is not an honor; it is a serious and responsible endeavor that should not be undertaken lightly or in a cavalier fashion.

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[130] *Omnibus Budget Reconciliation Act of 1990*, Pub. L. No. 101-508, 101st Cong., 2d Sess. (5 November 1990), 1991-2 C.B.481, § 11602(e)(1)(A)(ii).

Design of Wills and Trusts

Too many mistakes are made in the design of wills and trusts. Coupled with these errors are the mistakes made in not coordinating the form of property ownership and beneficiary designations of contract benefits with the provisions of the will and trust. Also, when a RLT is involved, legal title to property is either not conveyed to the trust during the trustor's lifetime or the conveyance documents are incorrectly prepared, thereby rendering the trust partially funded or completely unfunded. Furthermore, in this regard, it is not uncommon for a person with more than one state residence not to convey all of his or her property to a RLT. Most often, such a mistake is made because the person's focus is only on the property in the state of current residence. Even people who reside in only one state make the same error with real property that they own in other states.

Other errors made relative to the design and execution of wills and trusts include:

- Improper provisions for the apportionment of taxes and expenses. Tax apportionment clauses are critical to the proper allocation of taxes and expenses among beneficiaries when the decedent's estate includes property eligible for the tax-favored benefits of I.R.C. Section 303 (distributions in redemption of stock to pay death taxes) or when the I.R.C. Section 2055 charitable estate tax deduction is used for property passing to charity. Moreover, when a decedent's property is distributable by will (probate estate) and outside the will (nonprobate estate), unless attention is paid to tax-apportionment provisions, property in the probate estate may be used to pay taxes at the expense of the beneficiaries under the decedent's will. If such an arrangement is the estate owner's objective, fine; but, if the estate owner wants the beneficiaries under the will, and those persons receiving property from the decedent's nonprobate estate, to share in the taxes, then appropriate tax-apportionment provisions must be designed to accomplish the estate owner's purpose.
- Divorce can partially revoke the provisions of a will or trust which pertain to the decedent spouse's former spouse. The mistake made is in the identification of the spouse in the decedent's will or trust. A person can remarry, not change the will or trust, and then die; and the new spouse becomes the spouse mentioned in the will or trust. This can occur if the former spouse is not identified by name but is referred to only as *my spouse*. The decedent spouse's estate could be denied the estate tax marital deduction if it cannot be determined which spouse the decedent had in mind—the former spouse or the new spouse. On the other hand, the new spouse may receive all of the decedent's estate at the expense of the decedent's children by the former spouse. In such case, the estate tax marital deduction would be available to the decedent spouse's estate.
- Absence of successor personal representative or trustee. As previously mentioned, a will or trust cannot fail for want of a fiduciary. However, by not providing for a successor fiduciary, the decedent's beneficiaries may have to incur the unnecessary expense of petitioning a court to appoint a successor fiduciary.
- A person may lack testamentary capacity or may be under undue influence to effect a will or trust.
- Occasionally, drafting errors are made in the preparation of codicils to wills and amendments to trusts.
- Although rare, a will or trust can be rendered inoperative because of an insufficient number of witnesses to the testator's or trustor's execution of the instrument.

From the foregoing, it should be apparent that effective estate planning involves more than just transfer tax considerations. Even if the federal estate and generation-skipping transfer tax is, in fact, repealed after 2009, myriad reasons exist for the continued need to plan a person's estate.